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Siberia-to-Europe Pipeline: Status of Negotiations

Key Judgments

The softening of the oil and gas market over the past two years has reduced the amount of additional Soviet gas the West Europeans believe they will need beginning in the late 1980s. The change in the market has also increased the West Europeans' bargaining power with the Soviets over prices. Indeed, the uncertain demand picture in Western Europe probably was a factor in Moscow's decision early this year to scale down the Siberia-to-Europe pipeline project from two lines to one. [redacted] 25X1

The financing for the single line has been largely agreed to, at least in principle. Tough negotiations on gas prices, however, are still ahead. Moreover, the three major purchasers--West German, France and Italy--apparently are still not sure about the volume of gas they want. There is consequently a potential for lengthy delays, especially if projections of gas demand continue to decline. [redacted] 25X1

Despite the remaining uncertainties, the odds are high that the single pipeline will be built. It probably would take a major new event, such as a Soviet invasion of Poland, to halt it. Both the private and goverment sectors of the major West European countries are strongly in favor of the project, and all the skeptical of Algeria as a viable alternative. [redacted] 25X1

A second Soviet pipeline is another matter. Decisions on that project are unlikely for two or three years. In the interim, the West Europeans will obtain a better notion of future demand for gas and of the availability of alternative supplies, particularly from Algeria and Norway. Their perception of the market plus the financial and construction experience of building the first pipeline will be the major influences on their decision. [redacted] 25X1

The Changing Dimension of the Project

The Siberia-to-Europe pipeline project proposal has evolved through three stages since its inception in 1979 (see Table 1). Moscow backed off the original proposal last year due to technical problems and recently has reduced the scale of the second proposal in the face of competing domestic pipeline projects and a softer West European gas market. The initial proposal called for one 56-inch line with an unprecedented operating pressure of 100 atmospheres. (The largest Soviet gas trunklines currently operate at a maximum pressure of 75 atmospheres.) The 100-atmosphere line was to move up to 4.8 billion cubic feet per day (cf/d), with 3.9 billion cf/d earmarked for Western Europe and the rest for Eastern Europe. The Soviet Gas Ministry's reluctance to operate such a pipeline, however, prompted Moscow by late 1980 to propose a twin-line system operating at 75 atmospheres. The two lines, to be built

simultaneously, were designed to transport 5.8 billion cf/d, of which 4.6 billion cf/d could be delivered to Western Europe and the remainder to Eastern Europe. 25X1

In early 1981 Moscow changed its mind again, proposing construction of only one 75-atmosphere line. The Soviets have said that a second parallel line could be started in the mid-1980s, but Moscow apparently has made no commitment to do so. The single pipeline could move roughly 3.0 billion cf/d. Because a single line could be constructed more rapidly than two, initial deliveries probably could start by 1986, one or two years earlier than if twin lines were built. The single line would tap the giant Urengoy field--already in production--rather than the more distant and as yet undeveloped Yamburg field. The pipeline's route still has not been announced, but it probably will pass south of Moscow in order to minimize the amount of difficult pipeline construction in Arctic permafrost. The gas will transit Czechoslovakia to West Germany, where Ruhrgas will assume responsibility for West European distribution. 25X1

By scaling down the project, the Soviets apparently intend to reduce the burden on already overextended labor and equipment supplies needed to build their huge domestic gas pipeline system. Technical problems and high costs of developing the Yamburg deposit probably also contributed to the decision. 25X1

The hard currency cost of Western equipment and services for the single-line system could be as high as $10 billion, compared with up to $14 billion for two lines built simultaneously. The cost of a single line is so large because much of the same

infrastructure would be required for either one line or two. If a second line is built after 1985, total hard currency costs would probably exceed $14 billion due to higher prices of Western inputs. The second line nonetheless could be built faster than the first, since some infrastructure will have already been completed. 25X1

Moscow probably realizes that a scaled-down project is the best way of getting an early start on some sort of gas export deal at a time when projections of Western European gas demand in the 1980s may be revised downward. Delays in coming to an agreement with prospective West European customers would further postpone the time when hard currency earnings would flow from the project. If, as we believe, Soviet hard currency revenues from oil will have largely disappeared by 1985, the urgency of completing negotiations is obvious. 25X1

Where Negotiations Stand

There appear to be three major stages in the negotiating process for the pipeline--determining the financing for the equipment needed to build the line, setting the volume of deliveries and the price of the gas, and signing contracts for the equipment. In all stages the issues are complex and the players numerous. The role of the West European governments varies from country to country. In West Germany, separate negotiations are being conducted by banks, equipment manufacturers, and Ruhrgas, the privately owned gas utility; Bonn's only direct role has been to provide loan guarantees.

French and Italian Government officials, however, are directly involved in the negotiations. In addition, the potential buyers, Gaz de France and ENI, are state-owned, as are the major French banks and the Italian compressor and pipeline suppliers. [redacted] 25X1

The first stage of negotiations seems to be essentially over, even though many of the precise terms of the credits have not been set. Agreements in principle on financing the project were reached in July and August between the Soviets and West Germany, Italy, and the Netherlands. The results of French-Soviet talks scheduled for late August are unknown. The Soviets appear close to lining up as much as $11 billion for the deal, the bulk of which would be a mixture of official and officially backed credits. Of the total, these four West European participants appear ready to provide about $7 billion (at current exchange rates).[1] Japan will probably extend a sizable credit once West European financing has been firmed up. The West German financial package apparently will exclude credits for pipe, which are to be negotiated as part of the Soviets' annual orders. Interest rates have been agreed to in principle, although they could still change depending on the outcome of the negotiations on gas and equipment prices. As in previous deals, the West Europeans will attempt to close the gap between market interest

[1] Because of the sharp appreciation of the dollar, the dollar equivalent of these credits in August is about three-fourths of what it would have been at the beginning of the year.

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rates and the rates the Soviets want by manipulating either the price of the Soviet gas they buy or the cost of the equipment and engineering services they sell to the Soviets. 25X1

The next--and probably the most crucial--decisionmaking point in the pipeline negotiations could come later this month when Soviet officials are scheduled to begin talks with West European gas companies on the price and amount of gas. If agreement is reached on these issues, the negotiations on equipment contracts should follow almost automatically. We do not know, however, the volume of gas the West European countries will seek from the Soviets or what price they would pay. West Germany's Ruhrgas is probably in the process of revising downward its projections for gas demand for the 1980s and 1990s, particularly given recent consumption declines. The company now appears ready to talk seriously with the Soviets. The new French Government, however, is still studying future gas requirements as part of its review of overall energy supplies and policies. The Italians appear equally uncertain. 25X1

On prices, the West Europeans will negotiate individually, and prices probably would vary by country as they do under existing contracts for Soviet gas. The Soviets probably will seek a price equivalent with crude oil but are unlikely to get it. Given the current soft market for oil and gas in Western Europe, and the Soviets strong desire to get the pipeline under way, the Europeans should have considerable leverage on prices once volumes are firm. 25X1

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EVOLUTION OF THE SIBERIAN PIPELINE PROJECT

	Project Dimensions[1]				
Negotiating Period	Number of Lines	Diameter (inches)	Operating Pressure (atmospheres)	Possible Deliveries to Western Europe[2] (billion cubic feet/day	Hard Currency Costs of Pipeline Construction (billion US $)
1979-80	1	56	100	3.9	10-11
1980-81	2	56	75	4.6	12-14
1981	1[3]	56	75	2.9	9-10

[1] The length of the pipeline will depend on the route selected, but 3,000 miles (5,000 km) is the most likely.

[2] Assumes 20 percent of pipeline system's capacity goes to Eastern Europe as a transit fee, except in the one-line, 75-atmosphere version, in which all capacity may go to Western Europe.

[3] With the possibility of a second, parallel line being built after 1985.

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